

Selecting the Legal Structure for Your Business



Management

and

Planning

Series

Building America's Future

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INTRODUCTION

In starting a small business, one of the first questions you should ask is what form of legal entity you should use or "How should I organize my business?" Also, as your business grows and changes, you should from time to time ask yourself whether the entity you have chosen remains the best form of organization for your business.

The entities most commonly used by small businesses in the United States are (1) the sole proprietorship, (2) partnerships and (3) stock corporations. In discussing these entities, this publication answers the following questions:

- *Getting started*—How is each type of legal organization set up?
- *Control*—Who owns and who controls the business?

- *Liability*—Who is responsible if the business fails or has losses?
- *Continuity and transferability*—How long does each type of organization last, and how does the owner sell the business?
- *Taxes**—How are the profits and losses of the business taxed?

Also included is a summary of the pros and cons of the different legal entities and a table (Table 1) comparing a number of factors to consider when you select one of them for your business.

*This publication discusses basic federal income tax principles as they exist in 1991. Tax laws are frequently changed. For a detailed examination of federal taxes as they apply to small businesses consult the following Internal Revenue Service publications: *Tax Guide for Small Business*, Pub. No. 334; *Tax Information on Partnerships*, Pub. No. 541; *Tax Information on Corporations*, Pub. No. 542 and *Tax Information on S Corporations*, Pub. No. 589.

Table 1 – Comparison of Legal Entities

| | Difficulty and cost to form | Difficulty and cost to maintain | Risk of owner liability | Difficulty of tax preparation | Flexibility of ownership; bringing in new owners | Cost of terminating business |
|--------------------------|-----------------------------|---------------------------------|-------------------------|-------------------------------|--|------------------------------|
| Sole Proprietorship | Low | Low | High | Low | Low | Low |
| Partnership | Low to Moderate | Low | High | Moderate | Moderate | High |
| Corporation | High | High | Low | High | High | High |
| Subchapter S Corporation | High | High | Low | High | Low | High |

SOLE PROPRIETORSHIP

A majority of the small businesses in the United States are operated as sole proprietorships. This type of business organization is the simplest and is the form usually chosen by the one-person business, in which the owner and worker are the same person (although sole proprietorships can have employees). Its primary advantage is its ease of formation; its most important disadvantages are (1) it can have only one owner and (2) the owner is individually responsible for all losses of the business.

Getting Started

Selecting a Name and Beginning

You can start a sole proprietorship simply by beginning to conduct your business. You should open a separate bank account to keep track of your business's finances and keep records of all of the expenses and revenues connected with running the business.

A sole proprietorship is usually operated under the name of the individual owner, although other names can be used. If the name selected is not yours, you may be required to file a "fictitious name" certificate in the town, city or county in which your business is located. Care should be taken in selecting a name to ensure it is not the same or similar to the name of another business. Also, note that many states prohibit using the words "incorporated," "Inc.," "Corporation," "Company" or "Co." unless your business is a corporation.

Obtaining Permits and Licenses

Many states and localities require businesses to obtain business licenses or permits, no matter what type of entity is involved. Examples of the licenses often required are business licenses, zoning occupancy permits and tax registrations. You should call local government offices for information and application forms.

Control

Who Owns the Business?

If you create a sole proprietorship, all the assets of the business are owned directly by you. A sole proprietorship may be owned by only one individual—ownership by more than one person creates a partnership.

Who Controls the Business?

Generally, the owner of the sole proprietorship controls the business. If you are the owner of a sole proprietorship, you may hire employees to help you manage the business, but you will have legal responsibility for the decisions made by your employees and ultimate control over the business.

Liability

In a sole proprietorship, the business and the owner are one and the same. There is no separate legal entity and thus no separate legal "person." This means that as a sole proprietor you will have unlimited personal responsibility for your business's liabilities. For example, if your business cannot pay for its supplies, the suppliers can sue you individually. The business creditors can go against both the business's assets and your personal assets, including your bank account, car or house. (However, in some states, you may be able to protect your personal assets from business risks by owning them jointly with your spouse or by transferring them to your spouse or children. There may be tax and other reasons why this is

not a good idea; seek the advice of a lawyer first.) The reverse is also true; i.e., your personal creditors can make claims against your business's assets.

Insurance may be purchased to cover many of the risks of running a sole proprietorship. Some businesses are not very risky, so the personal liability may not be a great concern. However, you should understand that if you choose to operate your business as a sole proprietorship and lose money (which insurance will not cover), you will be personally liable for the loss.

Continuity and Transferability

How Long Does a Sole Proprietorship Last?

A sole proprietorship can exist as long as its owner is alive and desires to continue the business. When the owner dies, the sole proprietorship no longer exists. The assets and liabilities of the business become part of the owner's estate.

Can You Sell Your Business?

A sole proprietor can freely transfer a business by selling all or a portion of the assets of the business.

Taxes

A sole proprietor is taxed on all income from the business at applicable individual tax rates. The business income, and allowable business expenses, are reflected on the individual tax return. No separate federal income tax return is required of the sole proprietor. However, a proprietor must pay self-employment tax on the business income.

Pros and Cons

Pros

- Is inexpensive to start.
- Is simple to run.
- Has no double taxation on profits (see explanation under section on corporations).

Cons

- Owner has unlimited personal liability for business liabilities.
- Business has unlimited liability for owner's personal liabilities.
- Ownership is limited to one person.

There are two types of partnerships: general partnerships and limited partnerships. A *general partnership* is created when two or more individuals agree to create a business and to jointly own the assets, profits and losses. A *limited partnership* may be created only by following certain steps set out in each particular state's statutes. The primary advantage of partnerships is that they can have more than one owner; the most important disadvantage is that the general partners are personally responsible for the losses and other obligations of the business.

Getting Started

Start by Agreeing

You can start a general partnership by agreeing with one or more individuals to jointly own and share the profits of a business. There is no limit on the number or type of partners (i.e., individuals, other partnerships or corporations) you may have in your business.

A general partnership is deceptively easy to start because it can be formed by an oral agreement. However, it is advisable to have a written agreement signed by all partners addressing major issues relating to the business, including

- How much time and/or money the partners will contribute to the business.
- How business decisions will be made.
- How profits and losses will be shared.
- What will happen to the business and to a partner's share of the business if that partner dies, becomes disabled or stops working/contributing to the business.
- How long the partnership will exist.
- When the partnership will make distributions (i.e., payments of income earned based upon partnership share) to its partners.

A limited partnership consists of one or more general partners (i.e., those who are generally liable for the business) and one or more limited partners (i.e., those who have limited liability). If the statutory requirements are not followed, a limited partnership will be treated as a general partnership; therefore, it is important that you consult with an attorney in creating a limited partnership.

Selecting a Name/Filing Certificates

As with the sole proprietorship, partnerships often use the name of the partners as the name of the business. If all the partners' names are not used, or if none of the partners' names are used, you may have to file a "fictitious name" certificate. A number of states require partnerships to file partnership certificates either with the local government or in the office of the secretary of state or its equivalent. Check with your local government office to determine whether your state has such requirements.

Keeping Account

The partnership should keep separate bank accounts and financial records for the business so the partners know whether there are profits and losses, and how much of either they receive.

Control

Who Owns the Business?

The partnership agreement should state what percentage of the business and profits each partner will own. In the absence of an agreement, each partner will own an equal portion of the business and profits (as well as the liabilities) of the business.

Who Controls the Business?

The partnership agreement should specify who will control and manage the business of the partnership. In the absence of an agreement, all general partners have equal control and equal management rights over the business. This means that all of the partners must consent and agree to partnership decisions. It is important to note, however, that any partner can bind the partnership and the individual partners to contracts or legal obligations, even without the approval of the other partners.

In a limited partnership, the management and control of the business is handled by the general partners. State law restricts the types of control and management the limited partners can undertake without jeopardizing the limited partnership's existence.

Liability

General Partners

A general partnership has characteristics of both a separate legal entity and a group of individuals. For example, it can own property and conduct business as a separate legal entity. However, the general partners are "jointly and severally liable" for the partnership; i.e., all of the partners are liable together and each general partner is individually liable for all of the obligations of the partnership. This means that a creditor of the partnership could require you individually to pay all the money the creditor is owed. Your partners would then reimburse you for their share of the debt or loss. Before you decide to join a general partnership, determine whether your partners can financially afford to share the losses of the partnership. If you are the only partner with any assets or money, the creditors of the partnership can require you to pay them, and you will be unable to get reimbursement from your partners.

Limited Partners

Limited partners do not have personal liability for the business of the partnership. Limited partners are at risk only to the extent of their previously agreed-upon contributions to the partnership.

Continuity and Transferability

How Long Does a Partnership Last?

A partnership exists as long as the partners agree it will and as long as all of the general partners remain in the partnership. If a general partner dies or leaves the partnership, the partnership dissolves and the assets of the partnership must be sold or distributed to pay first the creditors of the partnership and then the partners. The partnership agreement may provide for the continuation of the business by the remaining partners, in which case it may not have to be sold upon the withdrawal of a general partner. When a general partner leaves a partnership, he or she is entitled to an accounting that will determine his or her share of the assets and profits of the partnership. The agreement should also cover how a partner will be paid for his or her share of the partnership when he or she leaves or dies.

Can a Partner Sell His or Her Share of the Partnership?

The partnership agreement should state whether a partner can sell his or her partnership share. In many states, the sale or transference of a partnership share cannot take place without the consent of all the other partners. Even if a partner does transfer a share of the partnership, he or she will remain personally liable for the business losses incurred prior to the sale of that interest.

Taxes

The partnership itself is not responsible for paying taxes on the income generated by the business. A partnership tax return is filed, but for informational purposes only. Instead, each partner individually pays taxes on his or her share of the business income. The profits and losses "flow down" from the partnership to the individual partners. (Recent changes in the tax law may restrict the use of partnership losses to offset income of the partner generated by activities outside of the partnership. Consult a tax advisor about these matters.) In certain cases, a partner may be required to pay tax on income from the partnership, even without having received any of the income. Partners must also pay self-employment tax on their partnership income.

Pros and Cons

Pros

- Is a very flexible form of business.
- Permits ownership by more than one individual.
- Avoids double taxation.
- Has few legal formalities for its maintenance.

Cons

- Partners have unlimited personal liability for business losses.
- Partnership is legally responsible for the business acts of each partner.
- General partnership interest may not be sold or transferred without consent of all partners.
- Partnership dissolves upon death of a general partner.

The stock corporation is more complex than the sole proprietorship or the partnership, but it has certain advantages that may make it worth considering as a business form.

A corporation is considered a separate legal entity; because of this, the owners of the corporation (known as its shareholders or stockholders) are not personally responsible for the losses of the business. Although a corporation usually has more than one owner, it is possible for only one individual to create and own 100 percent of a corporation.

A stock corporation may elect Subchapter S status for tax purposes. Once such an election is made, the corporation is referred to as a Subchapter S corporation. This election is discussed in the section on taxes.

Most states also recognize non-stock corporations, which are commonly used for nonprofit organizations, community associations, etc. There are no owners in a non-stock corporation, although there may be members. Because this form of corporation is rarely used by small businesses, it will not be further discussed in this booklet.

Getting Started

The Corporate Formalities

If you decide to do business as a corporate entity, you will have to comply with the formal requirements of state law to create the corporation. Note that members of certain professions, such as doctors or lawyers, may be required to do business as a professional corporation.

The individual(s) who will own the business (i.e., the shareholders or stockholders) must agree on the following to create a corporation:

- The name of the business.
- The total number of shares of stock the corporation can sell or issue (known as "authorized shares").
- The number of shares of stock each of the owners will buy.
- The amount of money or other property each owner will contribute to buy his or her shares of stock.
- The business in which the corporation will engage.
- Who will manage the corporation (i.e., who will be the directors and officers of the corporation).

Once the shareholders agree on these issues, they must prepare and file articles of incorporation or a certificate of incorporation with the corporate office of the state in which they want to incorporate. (A corporation may be formed in its home state or in any other state.)

Fees Paid to the State

You cannot form a corporation without filing with the appropriate state office. Most states charge an initial fee for filing the corporate documents and an annual fee for allowing the corporation to continue. These fees are sometimes based upon the number of shares of stock authorized and the par value of the stock. Because each state has its own rules and schedule of fees, call your state's corporate commission or secretary of state to determine what fees will apply to your business.

The corporation will also need bylaws, i.e., a set of rules of procedure by which the corporation is run. These include rules regarding stockholder meetings, director meetings, the number of officers in the corporation and the responsibilities of each officer.

Keeping Account

The corporation is a legal entity separate from its owners; therefore, it will need a separate bank account and separate records. The money and property that the shareholders pay to buy their stock, and the assets and money that are earned by the corporation, are owned by the corporation and not by the shareholders.

A Word About the Corporation's Name

When you send your corporate documents to the state, you must include the name of the corporation. If the name you have selected is already used by another company, your documents will be rejected. In many states, you can telephone the corporation commission and they will tell you whether the name you have selected is available as a corporate name. You also should take care to avoid using a name that is similar to that of an existing company or product.

Control

The Owners Have Ultimate Control

The shareholders of the corporation elect, at least once a year, a group of individuals to act as the board of directors. Usually, the directors must be elected by enough of the owners to represent a simple majority of

the outstanding shares, although a higher vote requirement can be required. Thus, those who hold a majority of the shares have ultimate control over the corporation. Terms of directors often are for more than one year and are staggered to provide continuity. Shareholders can elect themselves to be on the board of directors.

Certain major decisions must be approved by the shareholders, such as amendments to the articles of incorporation, merger with another company and dissolving the corporation. In some states, certain of these decisions require more than a majority of the shareholders to agree; be sure to consult an attorney about your state's voting requirements.

In some states, small businesses are permitted to incorporate without a board of directors or with other differences. Seek professional advice regarding what types of options may be permitted in your state.

The Board of Directors Makes Major Decisions

The board of directors is responsible for the major decisions of the corporation. It must meet at least once a year. Each director on the board is given one vote; usually the vote of a majority of the directors is sufficient to approve a decision of the board. Directors may be paid for their services, although payment is not required. The board of directors elects the officers of the corporation. The officers usually consist of a president, vice president, secretary and treasurer. In many states, one person may hold any or all of these offices.

Day-to-Day Decisions Are Made by the Officers

Officers of the corporation are responsible for running the day-to-day business of the corporation. Although they often are employees of the corporation and receive a salary, they can be nonemployees and/or serve without pay. The shareholders can be elected as officers.

How Do the Owners Get Paid?

If you own stock in a small business corporation and also work as an employee in that corporation, there are two ways you may be paid: (1) as an employee, you should receive wages or a salary for the work you perform and (2) if the corporation's business makes enough money, you may be paid a dividend or distribution on the stock you own. (A dividend must be paid equally to all shares of common stock and is usually expressed as an amount per share, such as "\$5 per share.") The board of directors decides whether dividends shall be paid. If dividends are not allowed in any given period, a shareholder has no right to any of the money the corporation's business has

made (except as an employee receiving a salary or wages). This is because the corporation is a separate legal entity, and the money it makes belongs to the corporation.

Liability

The most important reason for you to consider incorporating your business is because a corporation is its own legal "person," separate from its owners. This means, among other things, that creditors of the corporation may look only to the corporation and the business assets for payment. The individual shareholders are not personally liable for the losses of the business if the corporation is properly established and properly operated. The shareholders' only risk is their investment in the corporation.

There are certain cases in which shareholders do incur some liability for the corporation. For example, if the shareholders do not observe the statutory requirements for running the corporation or do not keep the corporation's money, accounts and assets separate from their personal accounts, then they may also be found to be personally liable for the business's losses. Also, if the shareholders "guarantee" the obligations of the corporation in order to borrow money or to rent space, for example, then they are legally responsible for the obligations guaranteed. Finally, if shareholders make loans to the corporation and the business fails, their loans may be paid off only after the other loans of the corporation are paid.

Continuity and Transferability

The corporation, as a separate legal person, does not cease to exist if one or more of its owners dies. Its corporate existence lasts as long as its shareholders decide it should; a corporation's "life" is usually perpetual.

Ownership of a corporation can be transferred by sale of all or a portion of the stock. Additional owners can be added either by selling stock directly from the corporation or by having the current owners sell some of their stock. (Before selling shares of stock to outsiders, check to see whether federal or state securities laws permit the sale.)

Small businesses that are corporations are often owned by a small group of shareholders who all work in the business. Often these shareholders formally agree to certain restrictions on the sale of their shares, so they can control who owns the corporation.

Taxes

The corporation must file its own income tax returns and pay taxes on its profits. The corporation must report all income it has received from its business and may deduct certain expenses it has paid in conducting its business.

Double Taxation

Dividends paid to shareholders by the corporation are taxed to each shareholder individually. This is why there is said to be a "double tax" on corporations. The corporation must pay taxes on its profits, and the shareholders must pay taxes on the dividends paid to them from the profits.

Subchapter S Corporations

You may elect Subchapter S status for your small business corporation if it meets the following requirements: (1) the corporation has no more than 35 shareholders; (2) the corporation has only one class of stock; (3) all of the shareholders are U.S. residents, either citizens or resident aliens; (4) all of the shareholders are individuals (i.e., no corporations or other entities own the stock) and (5) the corporation operates on a calendar year financial basis.

To elect Subchapter S status for your business, you will need to complete Federal Form 2553 and, in some states, file a separate state election form.

Generally, a Subchapter S corporation does not pay taxes on the income generated by the business. Instead, the income or losses are passed through to the individual shareholders and reported on their tax returns. The income or losses are divided among the shareholders based upon the percentage of stock of the corporation that they own.

You may be required to pay tax on the income of a Subchapter S corporation even if you have not been paid any money (i.e., dividends or distributions) from the corporation.

Pros and Cons

Pros

- Provides limited liability to owners.
- Is easy to transfer ownership.
- Is easy to add additional owners/investors.

Cons

- Is more costly to set up and maintain.
- Requires separate tax returns.
- Is subject to double taxation.

SUMMARY

The decision of what entity to select for your business may be very complicated. This booklet provides fundamental information regarding each type of entity, but your state's laws may be different, or there may be

additional factors for you to consider that are more complicated than those discussed in this booklet. Consult an attorney before deciding which structure is best for your business.

U.S. Small Business Administration (SBA)

The SBA offers an extensive selection of information on most business management topics, from how to start a business to exporting your products.

This information is listed in *The Small Business Directory*. For a free copy write to: SBA Publications, P.O. Box 1000, Fort Worth, TX 76119.

SBA has offices throughout the country. Consult the U.S. Government section in your telephone directory for the office nearest you. SBA offers a number of programs and services, including training and educational programs, counseling services, financial programs and contract assistance. Ask about

- **Service Corps of Retired Executives (SCORE)**, a national organization sponsored by SBA of over 13,000 volunteer business executives who provide free counseling, workshops and seminars to prospective and existing small business people.
- **Small Business Development Centers (SBDCs)**, sponsored by the SBA in partnership with state and local governments, the educational community and the private sector. They provide assistance, counseling and training to prospective and existing business people.
- **Small Business Institutes (SBIs)**, organized through SBA on more than 500 college campuses nationwide. The institutes provide counseling by students and faculty to small business clients.

For more information about SBA business development programs and services call the SBA Small Business Answer Desk at 1-800-U-ASK-SBA (827-5722).

Other U.S. Government Resources

Many publications on business management and other related topics are available from the Government Printing Office (GPO). GPO bookstores are located in 24 major cities and are listed in the Yellow Pages under the "bookstore" heading. You can request a *Subject Bibliography* by writing to Government Printing Office, Superintendent of Documents, Washington, DC 20402-9328.

Many federal agencies offer publications of interest to small businesses. There is a nominal fee for some, but most are free. Below is a selected list of government agencies that provide publications and other services targeted to small businesses. To get their publications, contact the regional offices listed in the telephone directory or write to the addresses below:

Consumer Information Center (CIC)

P.O. Box 100
Pueblo, CO 81002

The CIC offers a consumer information catalog of federal publications.

Consumer Product Safety Commission (CPSC)

Publications Request
Washington, DC 20207

The CPSC offers guidelines for product safety requirements.

U.S. Department of Agriculture (USDA)

12th Street and Independence Avenue, SW
Washington, DC 20250

The USDA offers publications on selling to the USDA. Publications and programs on entrepreneurship are also available through county extension offices nationwide.

U.S. Department of Commerce (DOC)

Office of Business Liaison

14th Street and Constitution Avenue, NW
Room 5898C
Washington, DC 20230

DOC's Business Assistance Center provides listings of business opportunities available in the federal government. This service also will refer businesses to different programs and services in the DOC and other federal agencies.

U.S. Department of Health and Human Services (HHS)

Public Health Service

Alcohol, Drug Abuse and Mental Health Administration

5600 Fishers Lane
Rockville, MD 20857

Drug Free Workplace Helpline: 1-800-843-4971. Provides information on Employee Assistance Programs.

National Institute for Drug Abuse Hotline:

1-800-662-4357. Provides information on preventing substance abuse in the workplace.

The National Clearinghouse for Alcohol and Drug Information: 1-800-729-6686 toll-free. Provides pamphlets and resource materials on substance abuse.

U.S. Department of Labor (DOL)
Employment Standards Administration
200 Constitution Avenue, NW
Washington, DC 20210
The DOL offers publications on compliance with labor laws.

U.S. Department of Treasury
Internal Revenue Service (IRS)
P.O. Box 25866
Richmond, VA 23260
1-800-424-3676
The IRS offers information on tax requirements for small businesses.

U.S. Environmental Protection Agency (EPA)
Small Business Ombudsman
401 M Street, SW (A-149C)
Washington, DC 20460
1-800-368-5888 except DC and VA
703-557-1938 in DC and VA
The EPA offers more than 100 publications designed to help small businesses understand how they can comply with EPA regulations.

U.S. Food and Drug Administration (FDA)
FDA Center for Food Safety and Applied Nutrition
200 Charles Street, SW
Washington, DC 20402
The FDA offers information on packaging and labeling requirements for food and food-related products.

For More Information

A librarian can help you locate the specific information you need in reference books. Most libraries have a variety of directories, indexes and encyclopedias that cover many business topics. They also have other resources, such as

- **Trade association information**
Ask the librarian to show you a directory of trade associations. Associations provide a valuable network of resources to their members through publications and services such as newsletters, conferences and seminars.
- **Books**
Many guidebooks, textbooks and manuals on small business are published annually. To find the names of books not in your local library check *Books In Print*, a directory of books currently available from publishers.
- **Magazine and newspaper articles**
Business and professional magazines provide information that is more current than that found in books and textbooks. There are a number of indexes to help you find specific articles in periodicals.

In addition to books and magazines, many libraries offer free workshops, lend skill-building tapes and have catalogues and brochures describing continuing education opportunities.

